momentum

Legal updates

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Taxation Laws Amendment Act No. 17 of 2017

Summary

The Taxation Laws Amendment Act No. 17 of 2017 (the Amendment Act) was promulgated in Government Gazette No. 41342 on 18 December 2017.

The following changes are relevant for the retirement fund industry:

1. A member will be entitled to transfer his retirement benefit after reaching normal retirement date to a retirement annuity fund.
2. The deduction of the pre-March 1998 tax-free built up in a public sector fund is extended to apply to one additional transfer.
3. The 12-month limitation on joining a newly established pension or provident fund has been removed.
4. The annuitisation requirement for provident funds has been postponed to 1 March 2019.
5. How taxable capital gains should be treated in determining the contribution deduction limit.
6. The foreign income exemption also applies to annuities paid by an insurer.
7. Other changes.

These changes are discussed in more detail below.

1. Transferring retirement fund benefits after reaching normal retirement date

The Income Tax Act was amended to allow a member to choose from which date he wants to receive his retirement benefit if the rules of his retirement fund allowed for it. This applied from 1 March 2015 – refer to Legal Update 2-2015 for more information about this change.

This amendment allowed a member to postpone his retirement date, subject to the rules of his retirement fund. The General Rules of the FundsAtWork Umbrella Funds were amended from 1 March 2016 to allow a member to postpone his retirement, retrenchment and disability benefits and become an inactive member. Refer to Legal Update 11-2016 for answers to the following questions:

a. When can a member elect to postpone the payment of his benefit?
b. What must the member do if he wants to postpone the payment of his benefit?
c. What happens when the member postpones the payment of his benefit?

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Not all funds are able to deal with inactive members after they have reached their normal retirement age. To enable these members to still postpone the date on which to take their retirement benefits, the Amendment Act has amended the definitions of 'pension fund', 'provident fund', 'retirement fund lump sum benefit' and "retirement interest" in section 1 of the Income Tax Act. It also amended paragraph 2 of the Second Schedule of the Income Tax Act and added a new paragraph 6A to that Schedule. These changes allow a member to transfer his retirement benefit to a retirement annuity fund from which he can then access it at a later date.

If a member of a provident fund transfers his retirement benefit to a retirement annuity fund, the rules of the retirement annuity fund will apply when he eventually takes his retirement benefit from the retirement annuity fund. That means that he will not be able to take the whole retirement benefit in a lump sum anymore, but will be limited to taking only one-third in a lump sum and buying a pension with the rest of his retirement benefit.

The industry requested that members also be allowed to transfer their benefits after retirement to pension and provident funds and to pension preservation and provident preservation funds. With regards to preservation funds, the proposal was to include specific amendments to disallow the "once off withdrawal", which allows a member who has transferred his resignation benefit to a preservation fund to make one withdrawal before retirement. The *Final Response Document on Taxation Laws Amendment Bill, 2017 and Tax Administration Laws Amendment Bill, 2017 (Based on report-back hearings to the Standing Committee on Finance and Select Committee on Finance in Parliament)*, dated 15 December 2017, states that *due to the difficult legislative amendments required and that there is little time for public comment on the proposed changes in the 2017 Draft TLAB, it is proposed that the proposed amendments be included in the 2018 legislative process* (see p16 of that document).

The amendments do not allow a member to stagger his retirement. A member who has reached his normal retirement date will have to take his full retirement benefit, whether he remains in the fund as an inactive member or transfers his benefit to a retirement annuity fund. He cannot take a part of it and leave the rest for a later date.

Effective date: 1 March 2018.

2. Tax exempt status of pre-March 1998 built up in public sector funds

A public sector fund is a pension fund defined in paragraphs (a) and (b) of the definition of "pension fund" in section 1 of the Income Tax Act. The Income Tax Act does not require that the rules of such a fund limit a member's lump sum retirement benefit to one-third. If the fund rules allow for it, a member of such a fund is allowed to take more than one-third of his retirement benefit in a lump sum; he may even take his whole retirement benefit in a lump sum, similar to a provident fund. A public sector fund which allows for more than one-third of the retirement benefit to be taken in a lump sum is classified as a "provident fund" in the Second Schedule to the Income Tax Act. Refer to Paragraph D of Legal Update 2-2016 for more details on public sector funds.

Up to March 1998, the lump sum benefits payable from public sector funds were not taxable. The Income Tax Act No. 28 of 1997 introduced tax on public sector funds from 1 March 1998. This only applied for benefits built up from 1 March 1998. To determine what portion of a member's lump sum benefit was to be taxed, Formula C was introduced in the Second Schedule to the Income Tax Act, which deals with the *computation of gross income derived by way of lump sum benefits*. The formula was moved to paragraph 2A under the Taxation Laws Amendment Act No. 22 of 2012.

Paragraph 2A, read together with paragraphs 2(1) and 2C, sets out what part of a public sector fund's member's lump sum retirement benefit must be included in a member's "gross income" as defined in section 1 of the Income Tax Act. Amounts so included will form part of the member's taxable income.

Paragraphs 5 and 6 of the Second Schedule set out what amounts should be deducted from lump sum benefits before the tax tables are applied. Paragraph 5 applies to withdrawal benefits, while paragraph 6 applies to retirement benefits.

Section 52 of the Taxation Laws Amendment Act No. 8 of 2007 amended paragraph 6 of the Second Schedule to provide that the tax-free amount calculated under the old Formula C would be allowed as a deduction before the tax on a **withdrawal** benefit is calculated, if a benefit has been transferred from a public sector fund to a pension fund, provident fund or retirement annuity fund. That amendment came into operation on 1 March 2006 and applied to a lump sum benefit received or accrued on or after that date. The implication of that amendment was that the deduction would only apply to transfers from 1 March 2006. Section 62 of the Taxation Laws Amendment Act No. 17 of 2009 expanded these deductions to apply to transfers to “such funds”. Section 84 of the Taxation Laws Amendment Act No. 7 of 2010 changed “such funds” to “a pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund”. The amendment came into operation on 1 March 2009 and applied to a lump sum benefit received or accrued on or after that date, which means that it applied to benefits transferred on or after 1 March 2009.

Section 61 of the Taxation Laws Amendment Act No. 17 of 2009 amended paragraph 5 of the Second Schedule to provide that the tax-free amount calculated under the old Formula C would be allowed as a deduction before the tax on a **retirement** benefit is calculated, if a benefit has been transferred from a public sector fund to a pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund. That amendment came into operation on 1 March 2009 and applied to a lump sum benefit received or accrued on or after that date. The result of that amendment was that the deduction would only apply to transfers from 1 March 2009.

The history as set out above can be summarised as follows:

Amendment Act	Change	Effective date
ITA No. 28 of 1997	Public sector fund benefits taxed	1 March 1998
TLAA No. 8 of 2007	Tax free benefit carried forward to first transfer to pension fund, provident fund or retirement annuity fund qualifies as deduction on **withdrawal** (par 6)	1 March 2006
TLAA No. 17 of 2009	Tax free benefit carried forward to first transfer to pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund qualifies as deduction on **retirement** (par 5)	1 March 2009
TLAA No. 17 of 2009 & 7 of 2010	Tax free benefit carried forward to first transfer to pension fund, **pension preservation fund**, provident fund, **provident preservation fund** or retirement annuity fund qualifies as deduction on **withdrawal** (par 6)	1 March 2009

Paragraphs 5 and 6 of the Second Schedule to the Income Tax Act allowed for the “transfer” of the tax free amount determined with the formula when a member transferred his benefit from a public sector fund to a pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund. When the member then withdrew or retired from the receiving fund, he would be entitled to deduct the tax-free portion from his withdrawal/retirement benefit, in addition to all the other deductions allowed under paragraph 5 (for retirement benefits) or paragraph 6 (for withdrawal

benefits). This deduction of the pre-March 1998 tax-free built up only applied on the **first** transfer from the public sector fund.

The Amendment Act changed paragraphs (5) and (6) to allow for the deduction to apply for one additional transfer. This means that if a member in a public sector fund transferred to a pension fund after 1 March 2009 and now transfers to another pension fund after 1 March 2018, he will be entitled to the deduction of the tax free amount determined under the formula in paragraph 2A of the Second Schedule.

The tax free portion is calculated as follows:

Lump sum transferred – amount determined under the formula = tax-free amount.

Effective date: 1 March 2018.

3. Removing the 12-month limitation on joining a newly established pension or provident funds

Proviso (c)(ii)(cc) of the definition of "pension fund" and proviso (b)(iii) of the definition of "provident fund" in section 1 of the Act provided *that persons who immediately prior to the said date were employed by the employer and who on the said date fall within the said class or classes may, on application made within a period of not more than 12 months as from the said date, be permitted to become members of the fund on such conditions as may be specified in the rules.* This meant that someone who was an existing member on the date that an employer joined a fund had the right to decide whether he wanted to be a member of that fund or not. That choice had to be made within 12 months from the date on which the employer joined the fund. Once the member joined the fund, he had to stay on the fund for as long as he met the eligibility requirements. If a member did not choose to join the fund within that 12 month period, he lost the right to become a member of the fund.

These provisos were impractical. For one, the fund would not know whether an employee was employed by the employer on the date that the employer joined the fund. The employer only advised the fund of the employees that would join the fund. If the employer were to add someone who was an existing employee 14 months after the employer joined the fund, the fund would be none the wiser and would see this as a new employee. Secondly, it led to a situation where some of the employer's employees who otherwise met the eligibility criteria were members of the fund while others were not; the latter could then potentially become dependent on state grants due to insufficient retirement provision.

The Amendment Act changed proviso (c)(ii)(cc) of the definition of "pension fund" and proviso (b)(iii) of the definition of "provident fund" in section 1 of the Income Act by removing the 12 month restriction. The implication of that is the existing employees do not have to elect within a specified period whether they want to become members of the fund or not; they can do so at any time. The rules of the fund may not prevent them from doing so. This could potentially lead to anti-selection where a fund provides lump sum disability benefits and a member chooses to become a member just to claim those benefits within a very short period of his membership starting. Funds will have to find alternative solutions to balance this increased risk.

Effective date: 1 March 2018.

4. Postponement of annuitisation requirement for provident funds to 1 March 2019

The one part of the T-day changes was the alignment of the tax treatment of contributions to all contributory retirement funds (pension, provident and retirement annuity funds). This was done from 1 March 2016 (refer to Legal Updates 3-2014 and 3-2016). The effect of this is that all contributory funds were treated equally as far as contributions were concerned.

The second part of the T-day changes, the annuitisation of provident funds as discussed in Legal Updates 4-2014 and 4-2016, was initially going to be implemented on 1 March 2016 as well. The effect

of this implementation would have been that both the contributions and the payment of benefits on all contributory funds would have been uniform, with the pre-T-day retirement benefits of provident funds being protected against annuitisation. The implementation of this second part of the T-day changes was postponed to 1 March 2018 to allow for further consultations between Government and the National Economic Development and Labour Council (NEDLAC) on social security reform. The Minister of Finance was due to report back to Parliament on the outcome of those consultations no later than 31 August 2017. The discussions on a comprehensive paper on social security have not been finalised yet; the Amendment Act provides that the Minister of Finance must table a report in the National Assembly not later than 31 August 2018. The implementation of the annuitisation of provident funds has also been postponed for another year.

Effective date: 1 March 2019.

5. Deduction of contributions to retirement funds

Before the alignment of the tax treatment of contributions from 1 March 2016, the deduction for employee contributions were contained in sections 11(k) [for pension funds] and 11(n) [for retirement annuity funds] of the Income Tax Act. Section 11(n) was deleted, and section 11(k) was expanded to include the deductions for employee contributions to all contributory funds (pension, provident and retirement annuity funds).

The new section 11(k) provided that an employer contribution would be taxed as a fringe benefit in the hands of the member. The member would then be entitled to deduct up to 27,5% of the higher of his remuneration and his taxable income, subject to a maximum of R350 000 per year, for both his and his employer's contributions. These deductions had to be taken into account by the employer in each month during which the fringe benefits tax was levied, which left the member in a tax neutral position if the total contributions were under the prescribed limits. Refer to Legal Updates 3-2014 and 3-2016 for more information about retirement contributions.

Unfortunately the new section 11(k) had its shortcomings. For instance, it was not clear how taxable capital gains had to be dealt with in determining what could be claimed as a deduction against retirement fund contributions.

The Amendment Act deleted section 11(k) and inserted a new section 11F. This new section limits the tax deductible contributions to the lesser of three amounts namely:

- R350,000;
- 27,5% of the higher of remuneration (excluding retirement lump sums, withdrawal lump sums and severance benefits) and taxable income (excluding retirement lump sums, withdrawal lump sums and severance benefits AND before deducting donations to Public Benefit Organisations), and
- Taxable income before tax deductible retirement fund contributions and excluding taxable capital gains.

The application of these limits is illustrated in the following example.

Mr T Payer earned a salary of R800 000.

He had rental income of R450 000. The expenses incurred to generate this rental income was equal to R200 000.

His employer contributed R80 000 to a provident fund on his behalf and he contributed R200 000 to a retirement annuity. He also had disallowed contributions of R120 000 that rolled over from the previous tax year.

He donated R5 000 (fully tax deductible as less than the legislated limit) to a charity.

He had a taxable capital gain of R100 000.

The maximum deduction that he can make is limited to the **lesser** of:

- **R350 000**,
- 27.5% of the greater of:

Remuneration	Salary + Employer contribution (taxable fringe benefit) = Total remuneration	R800 000 R 80 000 R880 000	27,5% of R880 000 = R242 000
Taxable income	Gross Income: salary fringe benefit rental income - Deductions expenses incurred in the production of income: rental expenses = Taxable income before taxable capital gains + Taxable capital gains = Taxable income	 R 800 000 R 80 000 R 450 000 R1 330 000 -R 200 000 R1 130 000 +R 100 000 R1 230 000	27,5% of R1 230 000 = **R338 250**

- Taxable income

Gross Income:		
salary	R 800 000	
fringe benefit	R 80 000	
rental income	R 450 000	
	R1 330 000	
- Deductions		
• expenses incurred in the production of income: rental expenses	-R 200 000	
• donations made to PBOs (section 18A)	-R 5 000	
= Taxable income	R1 125 000	**R1 125 000**

The deduction will be limited to the lesser of the three amounts in **bold**, which is **R338 250.**

Effective date: Deemed to have come into operation on 1 March 2016.

6. Foreign service: benefit paid by SA insurer

Section 10(1)(gC) of the Income Tax Act allowed a South African tax resident, who was employed outside of South Africa, to receive the retirement benefits that they earned/accumulated while outside of South Africa, free from tax.

This section was amended by the Taxation Laws Amendment Act No. 15 of 2016 to make it clear that the exemption does not apply to benefits received by a South African tax resident from a South African retirement fund. It will only apply to a benefit received from a foreign fund, and an amount transferred to a South African fund from a source outside of South Africa for that member. This only dealt with benefits paid by a fund, and not annuities paid by an insurer.

The Amendment Act now amended section 10(1)(gC) to include an annuity income paid by a South African insurer in respect of annuities to SA residents. This means that the annuity income of a South African resident arising from foreign services rendered will be exempt if it is paid by a foreign insurer, but will be taxable if it is paid by a South African insurer.

To broadly summarise then:

Tax resident of	Services rendered	Benefit paid by	Taxable / Exempt
South Africa	Outside SA	Foreign fund / insurer	Exempt
South Africa	Outside SA	SA fund / insurer	Taxable

Effective date: 1 March 2018.

7. Other changes

7.1 Section 10B(5): includes a provision that the foreign dividends exemption does not apply to any portion of an annuity.

7.2 Paragraph 12D of the Seventh Schedule: clarifies that the benefit referred is the “taxable benefit”. Effective date: Deemed to have come into operation on 1 March 2016.

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